June 19, 2003

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: File No. S7-11-03; Release No. 34-47849

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") appreciates the opportunity to comment on the petition ("Petition") by the Nasdaq Stock Market, Inc. ("Nasdaq") concerning the regulation of Nasdaq-quoted securities.[1] We urge the Commission not to take the extraordinary actions that Nasdaq requests. The Commission currently has sufficient tools to oversee the market for trading in Nasdaq securities, and those tools empower the Commission to take any action that may be necessary if, in fact, the problems described by Nasdaq do exist in that market.[2]

I. Nasdaq is Requesting Unprecedented Commission Action

The Release states that Nasdaq is concerned that there is "unequal and inadequate regulation by some markets that trade securities listed on Nasdaq."[3] The Release describes Nasdaq's logic as follows:

- "Nasdaq claims that when trading in Nasdaq stocks was almost exclusively limited to the Nasdaq system, NASD was able to view trading quickly and effectively in Nasdaq stocks and respond quickly and effectively to protect investors."
- "According to Nasdaq, the fragmentation of trading of securities listed on Nasdaq by various national and regional exchanges has caused the regulation of Nasdaq trading to become uncoordinated."
- "Nasdaq asserts that some markets are lowering their execution and reporting fees for trades in Nasdaq-listed securities."

[1] 68 F.R. 27721 (May 20, 2003) (the "Release").

[2] The ISE is a registered national securities exchange that currently trades only standardized options contracts. Unless we were to trade Nasdaq securities, the Petition would not directly affect us. However, the Petition requests that the Commission take extraordinary action that we believe would impede competition. We believe this would create an adverse precedent for all competitive markets, including the market for listed options.

[3] *See* Release at note 9 and accompanying text, 68 F.R. 27723. The Release quotes Nasdaq as inaccurately referring to securities "listed" on Nasdaq. Nasdaq is not a registered national securities exchange and thus no securities are "listed" on Nasdaq. Rather, Nasdaq is a facility of a registered national securities association, the National Association of Securities Dealers, Inc. ("NASD"), and stocks are quoted in this facility.

- "Nasdaq also states that, to hold down costs, these markets avoid incurring new regulatory expenses, such as the costs of adapting their existing rules and surveillance systems to the unique structure and patterns of Nasdaq trading."
- "According to Nasdaq, these markets use the savings from less regulation as an inducement to attract trading away from the NASD's highly regulated markets to less regulated markets, to the detriment of investors."[4]

To address these concerns, Nasdaq asks the Commission to intervene in three ways: (1) to use its authority under Section 19(c) of the Securities Exchange Act of 1934 ("Act") to amend the rules of all markets that trade Nasdaq securities to establish uniform Nasdaq trading rules and to ensure equal surveillance and enforcement of those rules; (2) to order that an exchange's costs of regulation, surveillance and enforcement with respect to Nasdaq securities be aggregated, and then deducted from the exchange's Nasdaq market data revenue; and (3) to prohibit markets with inadequate regulatory programs from trading Nasdaq securities.[5]

<u>II. Commission Action is Not Warranted</u>

Nasdaq's proposals are unnecessary and anticompetitive. To the extent that the problems Nasdaq describes do exist, the Commission has adequate remedial power with its currently-available tools. Nasdaq has not provided any reason for the Commission to intervene in the extraordinary manner proposed.

The Petition attempts to impose on other SROs Nasdaq's view of an acceptable regulatory program, as well as the amount such SROs should spend for regulating their markets. In submitting this Petition, Nasdaq ignores the historic precedent in every other competitive securities market, where each individual market place has been able to establish its own regulatory program for multiply-traded securities. Nasdaq's proposals are inconsistent with the Act since they would limit competition in Nasdaq-quoted securities and create a precedent for limiting competition in other securities.

Nasdaq also ignores the critical role of the Commission under the Act in overseeing the regulatory programs of SROs. The Commission's Division of Market Regulation reviews proposed rule changes from all the SROs, and in this role assures that such proposals are consistent with the Act. The Commission's Office of Compliance Inspection and Examination reviews the regulatory programs of the SROs on a regular and for-cause basis to assure that the SROs are adequately performing their regulatory responsibilities. The Commission staff has conducted these oversight functions looking at the unique aspects of each of the SROs it oversees, recognizing that a "one-size-fits-all approach" to trading rules, market structure and regulatory programs is not appropriate and would not benefit the market.

<u>II. There is Nothing Unique About Nasdaq to Justify the Nasdaq Petition</u>

<u>A. Competitive Markets Have Established Cooperative Regulatory Systems</u>

The Petition implies that the advent of competition in the trading of Nasdaq-quoted securities is a unique situation requiring Commission intervention to prevent a

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[4] All quotes are from Section II.B. of the Release, 68 F.R. at 27723.

[5] Nasdaq appears to use the terms "exchange" and "market" interchangeably. For the purpose of this letter, we assume that, in using the term "market," Nasdaq is referring only to self-regulatory organizations ("SROs") such as the NASD and registered exchanges. Because Nasdaq's proposed relief would apply only to SRO's, we assume that Nasdaq is not seeking Commission action that would directly affect other trading venues, such as alternative trading systems.

regulatory "race-to-the-bottom." Nothing could be further from the truth. There are at least two recent examples where competing securities markets have worked together to establish effective intermarket regulatory programs.

First, the market for listed equities historically has involved many market participants: the primary markets; the regional exchanges; and the "third market," including both Nasdaq itself and other over-the-counter trading reported through the NASD. These different markets, including Nasdaq, have different structures and trading rules, and competed for order flow based on a variety of factors, including the depth and liquidity of the market and the efficiency and cost of the trading venue. This competition has resulted in innovation and efficiency to the benefit of investors, and we have seen no evidence of inappropriate competition focused on limiting regulatory costs or programs. Instead, we believe the Act, and the Commission's oversight thereunder, has provided the appropriate regulatory safeguards while encouraging competition.

The listed options market also is an example of where multiple exchanges trade the same product. While the trading of the underlying stocks often is concentrated on the primary markets, there is fierce competition in equity options trading, generally with no exchange accounting for more than a third of overall trading volume. The options exchanges have achieved competition without any sacrifice in regulatory diligence. Each of the five options exchanges has an established regulatory program subject to active Commission oversight and inspection. We also work together through the Intermarket Surveillance Group ("ISG") to coordinate our regulatory activities. Furthermore, the ISG is working with the Commission staff to implement the Consolidated Options Audit Trail System ("COATS"), which will further enhance our regulatory efforts. Despite the active competition in this market, the options exchanges have accomplished these regulatory enhancements in a cooperative working environment in less than four years since the onset of wide-spread multiple trading.

<u>B. Nasdaq's Areas of Concern are Subject to Adequate Regulation</u>

Nasdaq fails to explain why the regulatory models in the equity and listed options markets would not work for Nasdaq-quoted securities. The Petition also fails to justify why Nasdaq's should be permitted to impose its proprietary view of what constitutes "appropriate" regulation on its competitors. In this regard, the Release simply states:

> Nasdaq states that it attempted, unsuccessfully, to persuade the other exchanges that trade Nasdaq stocks to act jointly to adopt uniform market rules and surveillance and enforcement mechanisms to eliminate these regulatory disparities. Specifically, Nasdaq asked that the [plan governing the trading of Nasdaq securities] be amended to prohibit certain defined conduct. Under that proposal, so-called Prohibited Conduct would have included, without limitation: any activity that is prohibited by any provision of the Act or rule adopted under the Act, market manipulation, illegal short selling, insider trading, fraud, front running, marking the open or the close, and non-compliance with the limit order display rule and firm quote rule. [Footnote omitted.]

Virtually all the rules in the Petition for Commission action under Section 19(a) cover conduct already prohibited under the Act, and the Act requires SROs to enforce not only their own rules, but also the Federal Securities Laws. There are only two areas that are not specifically covered by the Act: (1) "illegal short selling," and (2) a uniform consolidated audit trail. We discuss the consolidated audit trail in the next section. With respect to short selling, Nasdaq has adopted its own short sale rule beyond what the Act requires for other markets in unlisted securities. Nasdaq has not explained why its short-sale rule is necessary across SROs, and the Commission has not seen the need to adopt its own rule in this respect. Thus, we believe that each SRO should determine whether it believes such a rule is of benefit.

C. There is no Basis for Nasdaq's Proposed "Consolidated Regulation"

The Petition states that "Nasdaq believes that consolidated regulation protects investors better than the coordinated regulation that ISG facilitates." This statement ignores the careful balancing between regulation and competition envisioned by the Act and the Commission's role thereunder. While we question whether a competitive market structure adds any cost to regulation, even if it does we strongly believe any such costs are more than offset by the benefits of competition. There is no evidence of a regulatory crisis in Nasdaq securities that would justify the restructuring of SRO responsibilities into a single regulator. Indeed, Nasdaq presents no evidence that the regulatory programs of the other SROs are inadequate, other than simply concluding that these SROs do not have the same rules and regulatory programs as Nasdaq.

Taken together, Nasdaq's proposals would require SROs trading Nasdaq securities to adopt a regulatory program based on Nasdaq's model. Incurring the costs of such programs may not be necessary when Nasdaq securities are traded on an Exchange with auction market principals; those costs also could well limit the ability of these SROs to compete against Nasdaq. The structure of most exchanges is fundamentally different than Nasdaq and so their approach need not necessarily be the same. Nasdaq is not qualified to oversee the actions of its competitors, nor to determine what is an appropriate level of regulation by such exchanges. That is the role of the Commission in its oversight capacity and as the only neutral party in the competitive environment created under the Act.

In this regard, the Petition's discussion of a uniform audit trail for Nasdaq data is not actually a trading rule, but an argument for consolidated regulation. The Petition acknowledges that the NASD receives quotes and trade reports from ISG regarding transactions in Nasdaq securities executed on the regional exchanges. The Petition states, however, that this information "is not provided in a format that is conducive to integration into NASD's automated surveillance systems" which requires NASD to manually process information in a time-intensive manner. Thus, this discussion appears more an issue of reducing NASD's costs to process data and its desire to have its competitors accommodate the NASD's system, than regulatory necessity. If there is a legitimate need to improve the ISG audit trail, the markets should act jointly to do so, without necessarily being forced to adopt Nasdaq's proprietary audit trail, which may have requirements not necessary in an auction market system.

Nasdaq also inappropriately dismisses the existing intermarket regulatory structure. ISG provides the necessary framework for the SROs to coordinate their surveillance programs without mandating that all SROs undertake identical programs. To the extent that more formal coordination is necessary, SROs can enter into agreements under Rule 17d-2 under the Act (subject to Commission approval) to allocate their regulatory responsibilities for common rules and common members. The Commission has plenary authority to oversee these programs to ensure that each market is meeting its responsibilities as an SRO. These rules and procedures have worked well in every other market; there is every reason to believe they can work in a competitive market for Nasdaq securities.

D. There is No Basis to Allocate Regulatory Costs

Even more inappropriate than calling for mandated trading rules and consolidated regulation is Nasdaq's proposal to establish the regulatory budgets of its competitors by proposing that the total regulatory costs among the competitors be paid "off the top," prior to the sharing of market data revenues. Nasdaq provides no basis to justify its proposed "socialization" of regulatory budgets, and it appears to us to be nothing more than a thinly-veiled attempt by Nasdaq to foster its ultimate goal of having a "single regulator" for its competitive advantage.[6]

There is nothing in the Act linking market data revenues to regulatory budgets of SROs. We fail to see any basis whatsoever for this particular revenue source to be singled-out as the source of funding for regulatory programs – other than Nasdaq's control of the funds through operation of the securities information processor from which the revenues are generated.

Paying regulatory costs out of market data revenue also would allow Nasdaq to take money out of the pockets of its competitors to pay for its own surveillance program. Rather than distributing net revenue directly to the other SROs, Nasdaq would first pay the cumulative regulatory costs out of this fund, with Nasdaq certainly having the highest regulatory costs. This would increase market data payments to Nasdaq and reduce payments to its competitors. This system also would effectively reward the SRO with the highest regulatory costs, and reduce incentives to streamline regulatory services. While we do not believe that SROs should compete by lowering regulatory costs and services, we do believe that there should be incentives for SROs to keep all their costs low. If Nasdaq can subsidize a high-cost regulatory structure with funds that otherwise would be distributed, at least in part, to its competitors, there is reduced incentive for Nasdaq to be more efficient and to reduce the overall regulatory costs to the industry.

Finally, whether an SRO uses market data revenue or revenue from other fees or business returns to fund its regulatory program is irrelevant. Moreover, whether market data revenues exceed the amount actually spent on an SRO's regulatory program is irrelevant, even if it is possible to measure these costs accurately. The only thing that is relevant is whether an SRO has an adequate regulatory program for the securities it trades, the evaluation of which rests with the Commission, not an SRO's competitor.

IV. Conclusion

Adopting Nasdaq's proposals not only would hamper competition, but we also believe that it would stifle regulatory innovation. Upon our entrance into the market for listed options we developed a unique set of trading rules and a regulatory system tailored for our market. Nasdaq's proposed "uniform market rules" would stifle innovation in the market and limit the ability of an SRO to develop surveillance and regulatory systems suited for its own style of trading.

If Nasdaq believes that there are specific deficiencies in the coordination of information between SROs or with its competitors' regulatory programs, it should provide the Commission with the specifics of those deficiencies. The Commission could then use its existing regulatory powers to investigate Nasdaq's concerns, and, if necessary, institute remedial action. It is not appropriate for Nasdaq to seek to apply a uniform

[6] *See* the Release at Section III.B. Furthermore, we do not understand the mechanics of how this aspect of Nasdaq's proposal would work. It would be an administrative nightmare to determine what costs are "regulatory" and how to pay for those costs with market data revenue.

regulatory model on the industry based on its own proprietary views of market regulation.

We thank the Commission for the opportunity to respond to the Release. If you have any questions on our comments, please do not hesitate to call.

Sincerely,

Michael J. Simon
Senior Vice President and Secretary

cc: Annette Nazareth